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SIPDIS

SENSITIVE

NSC FOR BREIER, RENIGAR  
TREASURY FOR OASIA - DAS LEE AND FPARODI  
STATE PASS TO FED BOARD OF GOVERNORS FOR ROBITAILLE  
USDOC FOR 4332/ITA/MAC/WH/OLAC/JANDERSEN/ADRISCOLL/MWAR D  
USDOC FOR 3134/ITA/USCS/OIO/WH/RD/DDEVITO/DANDERSON/EOL SON

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TAGS: ECON EFIN PGOV EINV BR

SUBJECT: BRAZIL: CHIPPING AWAY AT THE FISCAL RESPONSIBILITY LAW

REF: Brasilia 321

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**¶11. (SBU)** Summary. Faced with the awkward prospect of enforcing the Fiscal Responsibility Law (LRF) against former Sao Paulo mayor, friend of Lula and prominent Workers' Party (PT) figure Marta Suplicy (reftel), the GoB has been less than coherent. Finance Minister Palocci sent to Congress a letter acknowledging that Suplicy had violated the law in taking out a loan to finance a public lighting program without the Finance Ministry's prior approval. Then, in an apparent about face, the GoB issued an executive decree that retroactively created an exception to the LRF for public investments of just that sort. Despite Lula Administration efforts to shield her, the matter may soon be out of the GoB's hands since Suplicy's replacement as Sao Paulo mayor, Jose Serra of the opposition PSDB, has forwarded to the municipal Accounts Tribunal (a fiscal oversight body) the final financial report for 2004, Suplicy's last year in office, indicating that her administration left uncovered obligations of over a billion Reals. In addition, State Deputy Alberto Goldman, the President of the Sao Paulo PSDB party filed a complaint with the Federal Public Prosecutor's office listing her alleged LRF violations. Prosecutors, we are told, are itching to get their hands on such a high profile case. For her part, Suplicy is reportedly considering a run in 2006 under the PT banner for the Sao Paulo state governorship. While the GoB's actions in this case have chipped away at the integrity of the LRF system, they have not yet struck its foundations. End Summary.

Marta's Law

**¶12. (SBU)** Apparent violations of the fiscal responsibility law (LRF) by Lula associate and prominent PT member Marta Suplicy during her 2001-2004 tenure as mayor of Sao Paulo (reftel) have put the GoB on the defensive. Finance Minister Palocci admitted in a January letter to Congress that one Suplicy administration action, the contracting of debt to fund a public lighting program without prior Finance Ministry approval, had violated LRF provisions restricting such actions by cities whose debt stock is above 120% of revenues. Shortly thereafter the GoB inserted in Provisional Measure (MP) 237, a decree dealing primarily with other issues, a few paragraphs that created a retroactive exemption to the LRF specifically for the type of investment in question. While four other cities also benefited from this rule change, no one doubts that the measure was meant to create an exemption for Suplicy's Sao Paulo administration. (Note: Meant to deal with urgent problems, provisional measures are a peculiarity of the Brazilian system. They are executive decrees with the force of law that take effect immediately upon publication. To become permanent legislation, however, they must be ratified by Congress, which in turn is required to vote on them within a defined time period. End note.) The MP has not yet been voted out of Congress, where some have questioned its constitutionality.

**¶13. (U)** The Finance Ministry separately issued a resolution changing the interpretation of "mid-course" debt ceilings, set by Congress at the same time the LRF was passed, so that they would not be binding for another decade. The debt ceilings at issue were set by Congress to limit states' and municipalities' ability to take out new debt. The GoB's action appears aimed at bypassing a somewhat arcane technical miscalculation in the inflation indexing that was used to correct state and city nominal debt stocks for inflation (reftel). The LRF uses an exchange rate-sensitive inflation index, the IGP-DI, to adjust for inflation the debt that states and cities owe the Federal Government. State and municipal revenues, however, tend to closely track consumer inflation levels, which are much

less exchange rate sensitive. This mismatch makes it possible for a state or municipality's debt to the GoB to grow much more quickly than its revenues, even without new debt. And, while Sao Paulo did take out some new debt, the bulk of growth in its debt stock was due to this indexation problem, setting the stage for a somewhat artificial violation of the Congressionally-set debt ceilings.

**14.** (SBU) Raul Velloso, a financial consultant and economist linked to new Sao Paulo mayor Jose Serra acknowledged to Econoff April 1 that the indexation mismatch needed to be addressed. He argued, however, that the GoB's approach, which boiled down to saying the debt ceilings will not be enforced in the near term, failed both to address the underlying technical problem and created the distinct impression that it was doing so to protect Suplicy. (Note: Most media that covered the issue sounded a note of alarm on precisely that point.) Velloso, however, was not worried that the vitiation of the debt ceilings would open the way for uncontrolled spending by the states and municipalities. He pointed out that the LRF's real procedural teeth were the requirements for prior Finance Ministry approval for contracting debt and the Federal Government's ability to withhold transfer payments to the states and municipalities should they miss debt payments.

**15.** (SBU) Reflecting on the Suplicy case, UN Economic Commission economist Carlos Mussi told Econoff that the GoB's actions raised clear concerns about its ability to maintain fiscal discipline among states and municipalities. Now that one exception had been made, he predicted that governors and mayors would be lining up at the Finance Ministry's door asking that they be given the similar treatment. While concerned, Mussi did not believe the GoB had undermined the foundations of the LRF.

Out of the GoB's Hands?

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**16.** (U) The Serra administration in Sao Paulo, meanwhile, has sent to the municipal-level Accounts Tribunal (a judicial branch fiscal oversight body) the final report on the city's accounts for 2004, the last year of the Suplicy administration. According to the Serra administration's calculations, Suplicy left over a billion Reals of bills to be paid, but only 379 thousand Reals cash on hand in city coffers at the end of 2004. It is a violation of the LRF for elected officials to leave unpaid obligations without the resources to cover them at the end of their administration. The Accounts Tribunal has 90 days to evaluate the financial accounts before deciding whether to accept or reject the annual report. If irregularities are found in the accounts, the Tribunal is expected to refer them to the Public Prosecutor's office (Ministerio Publico) for action.

**17.** (SBU) Independently, the state president of the PSDB in Sao Paulo last week filed a complaint with the Federal Prosecutor's office, with a case file on alleged breaches of the LRF under the Suplicy administration. According to Velloso, the primary accusation is that Suplicy did not leave funds to cover unpaid bills, a violation of the LRF. Velloso felt this alleged breach of the LRF, which includes the supplier debt that Suplicy reneged on as she left office (reftel), was much more serious than the separate violations of the debt ceiling and the procedural failure to get Finance Ministry approval for the public lighting program loan. MP 232 and the separate Finance Ministry resolution addressing the latter two points do not shield Suplicy from prosecution under the former. Velloso believed that the Municipal Accounts Tribunal would forward the case to the Public Ministry for prosecution within a few months. Velloso said the prosecutors were salivating at the thought of getting their hands on such a high profile case, implying that they would move the case to trial.

Comment

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**18.** (SBU) Other than looking the other way, the GoB appears not to have a strategy to deal with the Suplicy problem. This likely reflects the many directions it is being pulled by political forces and, within some parts of the GoB, a desire not to undermine the LRF. Those actions they have taken so far to protect Suplicy, however, have been unalloyed bad news. We nevertheless agree with Mussi that the foundations of the LRF system have not yet been shaken. The LRF system was designed to have a life of its own and gave other actors, such as the courts, the ability to press enforcement action. So, Suplicy may yet have her day in court. That alone would help shore up the LRF's credibility. On the parallel political track, the case promises to be a practice match for the 2006 elections, with the PSDB working to undermine the PT party's, and thereby the Lula Administration's carefully cultivated

image of fiscal responsibility.

**19.** (U) This cable was coordinated with Consulates Sao Paulo and Rio de Janeiro.

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